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SUBJECT: COOL ME DOWN: KAZAKHSTANI CENTRAL BANK'S DEPUTY CHAIRMAN
DISCUSSES OVERHEATING

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¶1. (SBU) Summary: In a January 19 meeting, Medet Sartbayev, Deputy Chairman of Kazakhstan's Central Bank, discussed with Charge d'Affaires the current state, the risks, and the outlook of the Kazakhstani economy. Sartbayev expressed his concern with persistent inflationary pressures, the real estate bubble, the strength of the tenge, and risks arising from the remaining weaknesses in the country's financial institutions. He emphasized, however, that the government is pursuing policies designed to address these problems. End summary.

THE HEAT IS ON

¶2. (SBU) Sartbayev, one of four Deputy Chairmen of the National Bank of Kazakhstan (NBK), supervises the management of the National (Oil) Fund's assets and issues of international cooperation. Speaking to the Charge, he readily acknowledged the inflationary pressures present in the Kazakhstani economy. Inflation, he said, reached 8.5% in 2006, and the NBK clearly recognized the real estate bubble as an issue. He cited a number of contributing factors, including burgeoning oil revenues, rapidly expanding borrowing by the commercial banking sector (which, he noted, stood at about \$20 billion at the end of 2006), corporate borrowing (roughly \$30 billion at the end of 2006), and an expansionary fiscal policy, particularly a 30% increase in government salaries over the course of 2006.

¶3. (SBU) Sartbayev concurred with the Charge's observation that wage growth was outpacing growth in productivity. This, he suggested, relates to a difficult structural problem, with the service sector dominating growth and industrial production (outside extractive industries) weakening. While industrial production rose 4.5% in 2005 and is expected to increase 6% in 2006, its rate of growth remains well below that of wages.

¶4. (SBU) Sartbayev emphasized that, given these pressures, the NBK will continue its policy of inflation targeting. He also expressed the hope that the new government would be more proactive in managing the budget's contribution to inflationary pressures. Sartbayev made it clear, however, that serious challenges remain. A key risk factor for 2007, he said, is the strong growth of unhedged short-term tenge positions taken by a number of financial sector actors (banks, hedge funds, etc.). He drew a parallel with the combined role of property and currency bubbles in Southeast Asia's financial meltdown of the late 1990's.

HOLD THAT TENGE

¶5. (SBU) Sartbayev turned to the NBK's role in the currency market.

(Note: the tenge's steady rise has posed a particular challenge to the NBK. The domestic currency's strength presents a major obstacle to the cornerstone of President Nazarbayev's stated economic policy: diversification away from the extractive sector. End note.) He described the August-October 2006 events (when the tenge sharply reversed its steady climb and gave back some ground to the dollar, falling from its peak of about 118 KZT / \$1 to around 128 KZT / \$1, as a "learning curve." Both the market and the NBK, he said, gained experience and understanding of the NBK role in managing the new mechanism for the National Fund (NF) (see reftel).

¶6. (SBU) The new mechanism, Sartbayev explained, compels the NBK to be quite active in the foreign exchange markets as it re-intermediates tenge receipts back into dollars and other currencies for investment in the NF. (Note: According to another NBK official, all but three or four "oil majors" with special agreements with the GOK are required to pay their taxes and fees to the government in tenge. End note.) Sartbayev cited the current softening of oil prices as a factor putting downward pressure on the tenge in the coming months, although he foresaw no significant depreciation in the first half of 2007.

¶7. (SBU) Note: The sudden tenge reversal of August-October 2006 attracted significant public attention in Kazakhstan. In December 2006, an NBK official cited to Econoff two causes behind the shift: the July 1, 2006 advent of the new NF mechanism (which "captures" and converts into foreign currency more of the GOK's oil revenues than the more leaky old mechanism did), and the NBK's open-market operations aimed at breaking the tenge's rise. The latter explanation dovetails with another insider's assertion that the NBK has been trying to "flush out offshore speculators" who are betting on the tenge's appreciation. Yet another well-informed observer told Econoff that the NBK was following the IMF's advice to "break the predictability" of the tenge's strengthening. The observer saw this policy as futile: as the NBK takes increasingly drastic measures to counteract the growing oil revenues' upward pressure on the tenge, the currency's future rise "is more predictable than

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ever." End note.

HOME IS WHERE YOUR MONEY IS

¶8. (SBU) Sartbayev was frank in addressing the issue of the housing bubble and responding to the Charge's remark that spiraling costs make housing unaffordable to many. (Note: Based on one estimate, at the end of 2006, mortgages comprised one-third of Kazakhstani banking system's credit portfolio. Prices for both residential and commercial property in Astana and Almaty now rival those in many Central European cities, in some cases approaching as much as \$2,000 per square meter. End note.) He observed that in addition to the need to restrain liquidity, the government should review its subsidies and other policies stimulating the construction industry. He also noted that the Anti-Monopoly Agency could act more effectively against oligopolistic behavior in the construction industry.

¶9. (SBU) Note: Sartbayev appeared to be implicitly underlining the linkage between construction, corruption, and the grey economy. In fact, Post has seen ample evidence, albeit mostly anecdotal, of the role of real estate in the grey economy. Astana and Almaty real estate is widely seen as a suitable safe haven for "parking" wealth away from the eye of the tax authorities. The public - and the press - have noticed that, despite rising rents, a striking number of premium apartments in Astana stand unoccupied; apparently, some owners simply do not bother renting their "investments" out. According to a well-informed westerner, the highest-end apartments are appreciating the fastest, another sign of housing being used as a speculative investment vehicle. End note.

A CAPITAL FOR YOUR CAPITAL

¶10. (SBU) Sartbayev emphasized the lack of alternative financial instruments as a key factor inflating the real estate market and

noted that there had been gaps and weaknesses in regulation. While reiterating the current risks to the financial sector, Sartbayev cited several factors that he expects will help mitigate these risks, particularly the initial phase of the realization of the "Almaty Financial Center," and the development of non-bank financial intermediaries. The emergence of these institutions, he said, could broaden and deepen the types and volumes of financial instruments available for trading, helping to alleviate the real estate bubble.

¶11. (SBU) Sartbayev also noted that the NBK was in early discussions to explore with the government - as well as key private sector financial actors - the possibilities for increasing the volume and lengthening the maturities of NBK and/or GOK paper in the market. He noted that having a suitable volume of government debt would make the exercise of monetary policy more efficient, but that in principle the NBK can and does plan to increase its issue in 2007.

¶12. (SBU) Note: The "Agency for the Regulation of the Almaty Financial Center" was established in 2006. While it has ambitious goals to transform Almaty into a regional financial powerhouse, the agency remains rather vague about its plans. In December 2006, it announced plans to build a trading platform alternative to the existing Kazakhstani Stock Exchange (KSE). The KSE, its volume dominated by block trades and its liquidity painfully low (bid-ask spreads, according to an insider, often amount to one-third of a listed stock's price), is a stock exchange that never quite managed to take off. By comparison, the Kazakhstani bond market, stimulated by government debt (always in high demand and low supply) and domestic companies' preference for issuing debt over equity, is significantly more developed. End note.

COMMENT

¶13. (SBU) Periodic (and limited) lapses in fiscal discipline aside, the GOK has traditionally pursued a very sound macroeconomic policy. Still, political interference remains a persistent risk. Great disparities in wealth distribution increasingly add to the pressure to raise government wages and pensions. Furthermore, as the National Oil Fund grows dramatically (from \$ 8 billion to \$14 billion in 2006), the idea of "investing" some of its assets within Kazakhstan is gaining prominence in the political discourse. Such a shift would unquestionably make the NBK's task of controlling inflation and holding down the tenge more difficult.

¶14. (SBU) As the Charge's discussion with Sartbayev demonstrates, GOK policymakers are highly cognizant of these risks as well as of the Kazakhstani economy's overdependence on oil. Indeed, the official policies (economic diversification, development of financial institutions, relative fiscal discipline) directly address these issues. The principal question lies in the implementation, particularly the government's ability and resolve to safeguard its

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initiatives from the pressures of politics and patronage. End comment.

ORDWAY